

MINUTES

MONTANA SENATE 57th LEGISLATURE - REGULAR SESSION COMMITTEE ON TAXATION

Call to Order: By **CHAIRMAN BOB DEPRATU**, on January 22, 2001 at 8:00 A.M., in Room 405 Capitol.

ROLL CALL

Members Present:

Sen. Bob DePratu, Chairman (R)
Sen. Alvin Ellis Jr., Vice Chairman (R)
Sen. John C. Bohlinger (R)
Sen. Mack Cole (R)
Sen. Pete Ekegren (R)
Sen. Jon Ellingson (D)
Sen. Bill Glaser (R)
Sen. Emily Stonington (D)

Members Excused: Sen. Dan Harrington (D)

Members Absent: None.

Staff Present: Lee Heiman, Legislative Branch
Deb Thompson, Committee Secretary

Please Note: These are summary minutes. Testimony and discussion are paraphrased and condensed.

Committee Business Summary:

Hearing(s) & Date(s) Posted: Senate Bill 2, 1/21/2001;
Senate Bill 240, 1/21/2001
Executive Action: Senate Bill 232

HEARING ON SENATE BILL 240

Sponsor: SENATOR WALTER MCNUTT, SD 50, SIDNEY

Proponents: Jerome Anderson, Attorney from Helena; Wes Welch, Cedar Creek Anti-cline; Perry Pierce, Burlington Resources; Patrick Montalban; Robert Fischer, President of Montana Petroleum Association; Gloria Paladichuk, Richland Economic Development

Opponents: None

Opening Statement by Sponsor: SENATOR MCNUTT stated the purpose of the bill was to eliminate the sunset dates in current law regarding reduced oil production taxes on certain oil well recovery techniques. He pointed out a cap was targeted to the price of oil which was \$30. The last two quarters that cap was triggered and they were not getting any tax benefits presently.

Proponents' Testimony: Jerome Anderson, representing Encore Acquisitions of Fort Worth, Texas, said that Encore purchased interests of Shell Oil Company and the Cedar Creek Anti-cline field in Southeastern Montana in 1999 and is operating that structure at the present time. The bill would not make any changes in production taxes. There is no effect on the budget. He described the historic background of the new drilling techniques, which had over 500 wells in production. The water flood secondary recovery program tried to squeeze more oil out. A new technique called horizontal drilling gets at production levels and answers the production of oil from old wells and new wells that might be drilled. **EXHIBIT (tas17a01)** He described past legislation. He said the sunsets in the prior legislation needed to be removed. The results under the current tax incentives had been very positive. The rates have encouraged Encore in their sales activity and had a positive effect on production. **{Tape : 1; Side : A; Approx. Time Counter : 2.3 - 9.5}**

Wes Welch, from Fort Worth Texas representing Encore Acquisition Company, testified to the committee. He said their company bought the Cedar Creek Anti-cline in 1999 from Shell. Encore is currently Montana's largest oil producer. Current production from this one site is 14,000 barrels a day plus 85,000 barrels of water. There are seven major fields that are in secondary recovery that these tax incentives apply. This field represents thirty percent of the state's oil production. They are currently under an aggressive capital program and are studying a CO2 tertiary application. They plan on spending forty million dollars in 2001 in the state in this Cedar Creek Anti-cline area. He described past studies by Shell regarding tertiary recovery capabilities that would potentially be available in this field in two to three years. They have created new injection patterns to optimize production and reentries of existing wells. He pointed out that Shell had 450 temporarily abandoned wells. These have been made into horizontal wells so Encore has taken a liability and turned it into an asset. Source pipelines have been the big hurdle in being able to get the source up to the anti-cline. This takes time and implementation can be three years. It is a very slow rate of return. Having the sunset provisions removed on that is a great benefit. The Montana Board of Oil and Gas has

been reviewing the seven major fields for the decline curves. The company is currently drilling injector wells, grass root wells and going back in to vertical wells with smaller tools and having production restored in areas. There are currently 300 horizontal applications being studied to see if this plan will continue to work on the fields. He summarized that the tax incentives have promoted additional development. They are targeted only for incremental production. These should be continued as they have added jobs through additional drilling and work especially in Eastern Montana. The additional production has resulted in incremental revenues from royalties in both the state and federal minerals and they feel this is very positive for the state and the industry. **{Tape : 1; Side : A; Approx. Time Counter : 9.5 - 13.9}**

Perry Pierce, Director of State Government Affairs for Burlington Resources, spoke in support of the bill. Burlington Resources is one of the more active oil companies in the state of Montana. He said they have been using the enhanced recovery rates adopted by the Legislature. The bill by removing the sunsets, would allow the lower rates to continue to encourage production in periods of low prices and was in the best interest of their business and the state. They conducted the nations first successful horizontal water flood. Injecting fluid has further increased recovery. These incentive tax rates should be continued. He pointed out the rates were only in effect when prices are lower. It does encourage companies to increase investment in the state of Montana. **{Tape : 1; Side : A; Approx. Time Counter : 13.9 - 26.4}**

Patrick Montalban, representing the Northern Montana Oil and Gas Association-a group of 70 small independents in Northern Montana, supported SB 240. The bill is important to the smaller groups who end up taking over the large water floods that have produced for years and the economics aren't there any longer. Their groups step in and produce the remaining barrels. It is important to look at the costs of the water floods which is a phenomenal capital expenditure. A separate line must be run to every well to inject the water. When it comes time to complete the millions of dollars of cost of laying these lines across the prairie, it is an original expense again rather than just drilling the wells. These are welded, high pressure lines that have to be buried six feet under or they will freeze in the winter. You then have to go to their injection plants which are a multi-million dollar operation. These are big triplex injection pumps if they are going to inject water, steam-which is more expensive, and CO2 is even more expensive. This project is a multi-million dollar capital expenditures. Small independents cannot afford this and cannot recover the money that the big

companies put in quickly. It takes a tremendous amount of time for the secondary recovery projects to kick in. The millions of dollars put in will not be recovered for at least a year or two years and sometimes much longer. Cumulative production is increased on the total reservoir. The Cut Bank field is the largest producing field in the United States. It produces over 130 million barrels of oil. The injection program in the 1970's in this field has been very successful and increased the reserve life of each one of those fields. This incremental production increases the total overall barrels from that reservoir. It is critical to the life of the wells, critical to Montana and critical to jobs. He asked the committee to support SB 240.

{Tape : 1; Side : A; Approx. Time Counter : 16.9 - 21}

Robert Fischer, President of the Montana Petroleum Association and Exploration Manager for Ballard Petroleum in Billings, spoke in support of the legislation. He pointed out the past legislation has worked. Over 120 million dollars has been invested in Southeast Montana since this legislation was enacted. Another 40 million will be invested in the coming year. The primary recovery of oil is an inefficient process. Secondary and tertiary recovery programs help the operator conserve the oil that is in the ground. It is much easier to go into a known oil field and squeeze more oil out of a known accumulation than it is to go exploring for those same oil reserves. It is important that the encouragement for the enhanced recovery projects move forward and stay in effect for all of Montana. The incentive for reentering idle wells is important. He asked the committee to be in favor of the sunset. **{Tape : 1; Side : A; Approx. Time Counter : 21 - 23.3}**

Gloria Paladichuk, representing Richland Economic Development in Richland County, spoke in support of the bill. She said the recovery projects were very important and they would like to see them continue.

Opponents' Testimony: None

Questions from Committee Members and Responses: **CHAIRMAN DEPRATU** asked for clarification about the price when it reached \$30 per barrel. **SENATOR MCNUTT** replied that was the cap and when the price of oil gets to \$30 the tax reduction goes away. **SENATOR BOHLINGER** asked if this was a way to rework abandoned wells as it seemed the tax incentive program enabled good conservation and an economic benefit. **Mr. Anderson** replied that the capability to use an old well for additional production was a benefit and also made it possible to extract additional oil from the ground that would otherwise still be there. Conservation and environmental impact were very positive. The Environmental Quality Council had

spent a day at the site and were impressed at the cleanliness of the structure. **{Tape : 1; Side : A; Approx. Time Counter : 23.3 - 30}**

SENATOR ELLIS asked about the \$40 million that would be spent. **Mr. Welch** replied this would go into drilling wells, re-completion of horizontal injectors and actual money put into capital improvements, also reclamation projects for abandoned wells. This money represents the budget for the Cedar Creek Anti-cline. There are 35 people employed full time at Baker, Montana. Wages are not included in the capital expenditure.

SENATOR STONINGTON said she thought the legislation was good. She asked about the qualified production. **Mr. Anderson** replied this only addressed the sunset that related to enhanced recovery. **{Tape : 1; Side : B; Approx. Time Counter : 1.6 - 4.6}**

SENATOR COLE asked if there were any other concerns with the bill. **Mr. Welch** noted the sunset provisions should be removed on the new wells as the seven units are in secondary recovery. Secondary recovery means you can drill a new well within an existing hole when it is in a secondary recovery unit. Not all wells are re-entered into the same hole, however. He noted as part of their capital program, they are drilling new wells. Horizontal wells cost up to a million dollars compared to a vertical well that would cost up to \$650 thousand. **{Tape : 1; Side : B; Approx. Time Counter : 4.6 - 6.1}**

SENATOR COLE asked about the 300 applications. **Mr. Welch** replied that could mean new wells, re-entries and injection patterns, and horizontal injection patterns to make it work. He noted there were 14 full time engineers that work on the Cedar Creek Anti-cline in comparison to Shell who had two engineers. That is how much attention this is given in getting the production up and being able to maintain it in the past two years.

Closing by Sponsor: **SENATOR MCNUTT** closed. He pointed out this has proven beneficial since the original legislation in 1995. These companies continue to spend money on development. **{Tape : 1; Side : B; Approx. Time Counter : 9.5 - 10.2}**

HEARING ON SENATE BILL 2

Sponsor: **SENATOR EMILY STONINGTON**, SD 15 Bozeman, presented SB 2.

Proponents: Robert Sands, individual taxpayer from Bozeman; Bruce Combs, attorney from Bozeman; George Bennett, Montana Banker's Association; Mary Whittinghill, Montana Taxpayers' Association

Opponents: Kurt Alme, Department of Revenue

Opening Statement by Sponsor: SENATOR STONINGTON presented SB 2. She said that agencies sometimes impose rules after a law is made that does not fit the intent of the Legislature. The Legislature can choose to clarify what that intent was through further legislative actions. SB 2 is one of these instances. This bill accomplishes two goals. It clarifies existing law and it rights a wrong to taxpayers who tried to comply but was poorly interpreted by the Department of Revenue and as a result these taxpayers were doubly taxed. This issue was unanimously agreed upon by the Revenue and Tax Committee and SB 2 was drafted as a committee bill. She explained the change in the federal law in 1997 regarding Chapter S Corporations which allowed Banks to become Chapter S Corporations. Chapter S Corporations are taxed at the individual level as a pass-through entity. The corporation passes through the income to its partners and they pay those taxes at the individual level. She explained that in Minnesota when the federal government allowed for banks to become Chapter S Corporations, Minnesota did not fully comply with federal law in passing it through to the individual level. They recognized the Chapter S status but taxed those corporations at the corporate level, even though they are pass through entities and to be taxed as if they were individual income. Minnesota continued to tax them at the corporate level, calling it a corporate or franchise tax measured by net income. However, in Montana, Chapter S taxes are paid at the individual level. When the taxpayer, **Mr. Sands**, encountered the problem when he paid his taxes in Montana, the Montana system kicked it out and did not allow him to apply the credit but required him to pay the taxes again at the individual level. He paid them once at the corporate level in Minnesota and when he went to pay them at the individual level and claim a credit against what had already been paid in Minnesota, Montana said he had to pay again. **Mr. Sands** has been paying his taxes under protest since that occurred. She explained the chart, Model for Proposed Legislation.

EXHIBIT (tas17a02) She discussed the law in Montana statutes that she relied on and the tax committee relied on to point out that the Department of Revenue was not interpreting this correctly.

EXHIBIT (tas17a03) The credit is allowed for a resident taxpayer for income taxes paid to another state. The same income is being taxed twice. She said SB 2 was a clarification of existing law.

{Tape : 1; Side : B; Approx. Time Counter : 10.2 - 22.2}

Proponents' Testimony: Robert Sands spoke as a proponent. He said he had practiced tax law for thirty years in Minnesota. Incomes, deductions and credits flows to the owner. The Department of Revenue had claimed that **Mr. Sands**, as a shareholder in a corporation, was trying to "shoe horn" itself into an S Corporation status. The statute said clearly that if you had a federal election you are an S Corporation in Montana, one standard. He said he was an ethical and straightforward taxpayer. The department has said if his corporation did business in Montana and filed in Montana he would be an S Corporation. However, the statute said if you file as an S Corporation in the federal government, you are an S Corporation in Montana. He asked the committee to look at this as an example of the way the Department of Revenue worked. This is an example of how residents in Montana are treated and the way the law is applied. He described the example of tax burden dividends and how the taxes become paid. **EXHIBIT(tas17a04)** He gave nine examples, seven of which were credits. He said that he could not think of a credit that did not flow through. Under the statute, 15-30-111, there is a reduction of income or federal taxes paid by the corporation, flow through. Charitable deductions, paid by the corporation, flow through. **{Tape : 1; Side : B; Approx. Time Counter : 22.2 - 30}** Statute 15-31-164, credit for contribution to qualified endowments, flows through. Statute 15-32-602, investment credit for depreciable property by the corporation, credit flows through. 15-50-205, 6 and 7, credit for contractors gross receipt tax paid by a corporation, flows through. 163, contribution to the University System or a college, paid by the corporation, flows through. 164, credit for alternative fuels to convert motor vehicles, paid by a corporation, flows through. 1-E credit for preservation of historic buildings done by the corporation, flows through. All nine cases are applicable in the state of Montana. **{Tape : 2; Side : A; Approx. Time Counter : 0 - 1; Comments : Missed a few of the cases cited as the tape was turned over.}** The controversial question was whether this bill represented a change in the law. **Mr. Sands** said this was not a change. This statute could say "but only if paid by the individual and not if paid by the corporation". **{Tape : 1; Side : B; Approx. Time Counter : 4.6 - 6.1}** Department of Revenue may wish those words were there. They are not in statute in that manner. All it says is the taxes are paid on the same income that you get the credit. **Mr. Sands** stated that he did not believe this was retroactivity but rather clarification. **{Tape : 2; Side : A; Approx. Time Counter : 1 - 1.8}**

Bruce Combs, an attorney from Bozeman, said **Mr. And Mrs. Sands** were his clients that he represented before the Department of Revenue in their litigation involving this statute. He said this legislation would be a clarification of statute and should be

retroactive as SB 2 provides. He presented exhibits, the first three of which were taken from 1991 legislation, exhibits provided to the taxation committee by **Jeff Miller**, the former Director of the Department of Revenue. **EXHIBIT (tas17a05)** At that time the federal election of S Corporations for state purposes, prior to 1991 you could opt out of state elections but still be one for federal purposes. The Department of Revenue wanted this to be mandatory. The first of their exhibits illustrates how a C Corporation were taxable at the corporation level and then taxable at the shareholder level. The second exhibit illustrated how an S Corporation was designed to work where profits and losses pass through and are taxable at the shareholder level. The Department of Revenue's third exhibit illustrated some of the other aspects of what was then known as SB 333, which passed. The bill affirmed the principal that residents are taxed on 100% of income to the extent taxed in another state they are allowed a credit against Montana liability. **Mr. Combs** stated this was 180 degree opposite of what the Department of Revenue's current position. The Department of Revenue's current policy is also inconsistent as to other credits. He pointed out that **Mr. Sands** went through the long list. He listed three of the currently permissible income tax credit flow-throughs in Exhibit D. **Mr. Sands** had included all of them. **Mr. Combs** noted that he was not aware of any of these credits that did not flow-through when it was paid at the corporate level with an S Corporation that was not afforded to shareholders at the individual level. The Department of Revenue's policy is inconsistent with respect to composite returns. It permits the credits to flow-through on composite returns but on non-composite returns it doesn't. The statute does not distinguish between composite returns and non-composite returns, but the Department of Revenue has adopted a policy that is inconsistent as to those taxpayers. The Department of Revenue's policy clearly discourages residents of Montana from investing in foreign and out-of-state corporations which is not a good policy for Montana. It also discourages non-residents of Montana to have ownership in out-of-state corporations from moving here. **{Tape : 2; Side : A; Approx. Time Counter : 1.8 - 7.6}**

George Bennett, representing the Montana Bankers Association, spoke in support of the bill. He said the association supported the bill because it was a matter of basic fairness. Taxpayers similarly situation should be taxed in a similar manner. Although the Sub-chapter S treatment had been around for awhile, Congress had denied it to financial institutions. At the time Congress changed its law, and Montana ties in to some of the federal definitions, the Montana Department of Revenue had intended to draft legislation to deny that Sub-chapter S treatment to Montana financial institutions. This would not have

been fair. He pointed out that banks, although part of the monetary system and heavily regulated, were run by a small group of stockholders or by a family. They have been allowed to use the Sub-chapter S election. The credits ought to flow through. This would come close to a denial of equal protection, but Congress did not feel that way. It is a matter of fairness. He urged the committee to pass the bill. **{Tape : 2; Side : A; Approx. Time Counter : 7.6 - 9.7}**

Mary Whittinghill, Montana Taxpayer Association, said this was a matter of taxpayer fairness and a clarification of tax law. She said it was appropriate to do retroactive application in this instance. **{Tape : 2; Side : A; Approx. Time Counter : 9.7 - 11.7}**

Opponents' Testimony: **Kurt Alme**, testified on behalf of the Department of Revenue. He said he opposed sections two and three of the bill. He supported section one. He said it was important to insure that taxpayers would be treated the same. When the department is wrong, the process to correct that mistake must be the same for everyone. Taxpayers can appeal the departments decision to the State Tax Appeals Board, to District Court or to the Supreme Court. He stated that in this case you are being asked to change the law to benefit one particular taxpayer, although other taxpayers may benefit. If the Legislature passes this bill retroactively, it will be giving these taxpayers a special process that other taxpayers do not receive. Most taxpayers are not able to have a legislator intervene on their behalf, they have to pursue their own appeal rights. By passing this bill the Legislature will also create a precedent for retroactively changing the law to benefit what appears to be a very small number of taxpayers. **{Tape : 2; Side : A; Approx. Time Counter : 11.7 - 18.9}**

Questions from Committee Members and Responses: **SENATOR EKEGREN** pointed out that it appeared the Department of Revenue could see that the interpretation was wrong since they were supporting section one, he asked why they should make the taxpayer go to the trouble and expense of having to go to court and work their way to the Supreme Court. **Mr. Alme** replied that they did not think their interpretation was wrong under current law. They do not oppose a change in tax policy going forward. **SENATOR EKEGREN** asked how many people would be affected. **Mr. Alme** said there were few people who would be impacted by this change, possibly less than ten.

SENATOR GLASSER asked if **Mr. Alme** wished to discourage any citizens right to ask for legislative relief when they feel they have been wronged. **Mr. Alme** said it seemed that taxpayers in

disputes with the Department of Revenue should be treated equally. He noted concerns with proper process. The State Tax Appeal Board and the District Court were available with rules of evidentiary procedure and due process protections for both sides. He said he had concerns for retroactive redress in a particular taxpayer situation. **{Tape : 2; Side : A; Approx. Time Counter : 27.4 - 30}**

SENATOR ELLINGSON noted that there were some good points brought out regarding the retroactive change in tax policy. Retroactive change in tax policy could create a number of concerns that are problematic. However, in this particular case, it appears compellingly obvious that this would be simply clarifying tax policy. He asked about the continued position by the department that the tax law was correctly applied in **Mr. Sands** case.

SENATOR ELLINGSON pointed out that the Department of Revenue had conceded that if **Mr. Sands** had paid this tax individually as opposed to through the corporation that he would have been entitled to that credit. **Mr. Alme** replied that he had not reviewed this particular case, however a final disposition had been issued in **Mr. Sands** situation which was adverse to him. There is a final decision. Negotiations can still be conducted, prior to a hearing before the State Tax Appeal Board. He asked the committee to reserve judgement on the case until hearing from both sides. There has not been a chance to lay out all the arguments. There is a significant body of case law on the state tax credit and the credit you get from other states. He was unsure how applicable it was to our law. The answer may not be so clear cut. He was concerned that all the facts and all the law be looked at first before making a decision. **{Tape : 2; Side : B; Approx. Time Counter : 3.1 - 6.9}**

SENATOR ELLINGSON said he was a member of the Revenue and Taxation Committee that had heard the Department of Revenue position months ago. He had heard the position of the department and the explanation. He said it was important to hear from **Mr. Alme** now why the Department was taking this position. **SENATOR ELLINGSON** said he had no problem with the retroactive issue if they were clarifying the law and not changing tax policy. He requested further explanation from **Mr. Alme** and that it be provided in written form before the committee takes executive action as to why the Department thinks this is not simply clarification. **Mr. Alme** replied that they were concerned that this was not the right forum at all to be arguing the merits of the case. **{Tape : 2; Side : B; Approx. Time Counter : 6.9 - 11.4}**

Closing by Sponsor: **SENATOR STONINGTON** said she believed this was an important issue. She pointed out that the final decision on **Mr. Sands** case occurred March 3, 2000. Eleven months later this case has had lots of opportunity to be resolved, but it is not. There was a hearing in front of the State Tax Appeal Board scheduled for last July that the department reneged on and asked to be delayed. The hearing was rescheduled for last October and the State Tax Appeal Board, hearing the Legislature had expressed interest in the case, cancelled the hearing. **SENATOR STONINGTON** stated she felt this was an appropriate forum for this issue. If a constituent is not getting adequate resolution through one of the state agencies it would be her responsibility as a legislator to try to express in policy that the department has not conducted itself in an appropriate manner. This case had adequate time and attention and nothing happened. She pointed out the **Sands** had been through the Office of Dispute Resolution for negotiations at the Department of Revenue and, according to the **Sands**, got an inadequate hearing. They did not get any negotiation. They then went to a hearing process through the department and got a final decision last March. *{Tape : 2; Side : B; Approx. Time Counter : 11.4 - 18.2}*

EXECUTIVE ACTION ON SENATE BILL 232

SENATOR ELLIS said he talked to **SENATOR MAHLUM** and told him the bill did not address the problems and he chose not to go forward with the bill at this time. **SENATOR ELLIS MOVED TO TABLE.** The vote was 7-2 with **SENATORS ELLINGSON AND HARRINGTON** voting No.

SENATOR GLASSER pointed out that those drafting this bill did not address the issues that **SENATOR MAHLUM** had brought forth.

ADJOURNMENT

Adjournment: 9:50 A.M.

SEN. BOB DEPRATU, Chairman

DEB THOMPSON, Secretary

BD/DT

EXHIBIT (tas17aad)